

**OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**

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Office of the Director

January 14, 2005

Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
U.S. House of Representatives
341 Cannon House Office Building
Washington, DC 20515-1806

Dear Chairman Baker:

Thank you for your letter of December 16, 2004. I appreciate the support that the Subcommittee has shown for the work of OFHEO.

In your letter, you request an "immediate determination" of Fannie Mae's capital adequacy. As you know, OFHEO is required, no less than quarterly, to determine the capital adequacy of both Enterprises. The Securities and Exchange Commission (SEC), based on OFHEO's September 17, 2004 "Report of Findings to Date" undertook a review of Fannie Mae's accounting. On December 15, 2004, the SEC directed Fannie Mae to restate accounting treatments for SFAS 133 and SFAS 91 for previously reported financial statements. The disallowed hedging treatments result in an estimated \$9 billion cumulative reduction in core capital as of September 30, 2004, as disclosed by Fannie Mae. This capital level places Fannie Mae below its minimum capital requirement. Fannie Mae's capital remains above the required critical capital threshold and Fannie Mae continues to meet its risk-based capital requirement.

On December 21, based upon all of the relevant information, I classified Fannie Mae as significantly undercapitalized as of September 30, 2004. I also directed Fannie Mae to provide OFHEO with a capital restoration plan to bring core capital into compliance with the minimum capital requirement plus a targeted surplus of 30% over the minimum capital requirement, as set forth under OFHEO's Agreement with the Fannie Mae Board of September 27, 2004. OFHEO is working with Fannie Mae's Board on the capital plan and its implementation. Once the capital plan is in place, OFHEO will monitor the enterprise's compliance to ensure that targets are met.

Concerning Fannie Mae's executive incentive plan, OFHEO's examination of the causes and the parties responsible for the improper accounting treatments used by Fannie Mae continues. OFHEO will take all actions appropriate to recapture excessive bonus payments, in addition to other amounts, that OFHEO finds were based upon false or misleading financial information or are otherwise excessive.

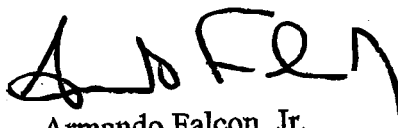
The Honorable Richard Baker

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OFHEO has a number of supervisory tools available in this regard. First, Fannie Mae may be directed to seek rescission of any applicable employment contracts and restitution or reimbursement of inappropriate payments through any available means. If Fannie Mae does not comply or its attempts are ineffective, OFHEO has the authority, through its cease and desist powers, to seek restitution and reimbursement directly against any executive officer or director to the extent that person was unjustly enriched or engaged in serious misconduct. Additionally, if the SEC determines that any of Fannie Mae's executive officers are required to forfeit bonuses or other compensation under Section 304 of the Sarbanes-Oxley Act of 2002, OFHEO will take appropriate enforcement actions, if necessary, against the company and those officers to ensure compliance.

Please contact me if you have any questions regarding these matters.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Armando Falcon, Jr.', with a stylized flourish at the end.

Armando Falcon, Jr.

Director